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AMERITECH

AMERICAN INFORMATION TECHNOLOGIES

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March 23, 1993

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Ms. Donna R. Searcy
Secretary
Federal Communications Commission
1919 M Street, N.W.
Room 222
Washington, D.C. 20554

Re: **CC Docket 92-24**
Ex Parte Statement

Dear Ms. Searcy:

At the request of the Common Carrier Bureau, Tariff Division, the attached material is being submitted by the Ameritech Operating Companies in the above referenced docket.

Sincerely,



cc: **Mr. Vogt**
Ms. Brown
Ms. Argentero
Mr. Frentrup

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Evaluation of LIDB Service Rates

This ex parte statement is a response to a discussion between the Ameritech Operating Companies (AOCs) and the Commission staff regarding the use of fully distributed cost (FDC) as a means to evaluate the reasonableness of rates for LIDB service. In this statement, the AOCs propose a different method

amount of the overhead assigned to the new service will vary depending upon customers willingness to pay for the new service.² In this case, LIDB service rates will be based on the prices of alternative services available and customers' willingness to pay for validation service provided that the AOCs cover their incremental costs and some overhead costs. Thus, the amount of overhead to be assigned to LIDB queries will be driven on the customers' willingness to pay for validation service, rather than a comparison to the mechanical FDC cost allocation process.³

In this regard, the AOCs have already demonstrated the reasonableness of their proposed LIDB service rates. At the time the AOCs filed their LIDB tariff, the major non-LEC validation service provider, which licensed the AOCs' and other LECs' data, charged \$0.038 per validation. The AOCs established their LIDB validation rate at \$0.03 per validation. The AOCs' service is a direct substitute for the alternative validation service. In addition, customers may use their Mastercard and VISA cards for telephone calls, resulting in charges to the interexchange carriers of approximately \$0.06 per transaction for linkage and authorization, equivalent to the LIDB query. See Appendix 2. Thus, the AOCs' LIDB service rates are reasonable when compared to alternative services. And, based on the direct cost information, the service rates recover all incremental costs as well as a sufficient amount of overhead.

A different type of competitive situation exists between the AOCs and US Intelco/Independent Telco Networks' (US Intelco) validation services.

² 6 FCC Rcd. at 4531 ¶ 44. In that order, the Commission said, "[o]nce the direct costs have been identified, LECs will add an appropriate level of overhead costs to derive the overall price of a new service. To provide the flexibility needed to achieve efficient pricing, we are not mandating uniform loading, but BOCs will be expected to justify the loading methodology they select as well as any deviations from it."

³ Comparison of overhead assignments to similar services or to a FDC method may be appropriate for certain services where no alternatives are available, such as interconnection.

Specifically, US Intelco is the AOCs' main data storage competitor and charges the AOCs \$0.065 per validation. On the other hand, the AOCs pay independent ILECs (ILECs) within the Ameritech operating region \$0.01 per validation of their data stored in the AOCs' LIDB. The compensation agreements were established because the AOCs recognized that ILEC data has value to its owners, and because storage of the data in the Ameritech LIDB minimizes the cost of validation for all users in the areas served by the AOCs.⁴ The AOCs' LIDB service rates were designed to cover the compensation costs of the ILECs. However, if the Commission requires the AOCs to decrease their LIDB rates, it is unlikely that the AOCs could continue to offer ILECs this competitive compensation arrangement. And, if the AOCs could not offer this competitive arrangement, ILECs most likely would use US Intelco to store their data. If the ILECs use US Intelco then carriers accessing the ILECs data would be charged US Intelco's \$0.065 rate for validation rather than the AOCs' proposed \$0.03 LIDB rate. Consequently, a decrease in the AOCs' proposed rate would force end users to pay a greater amount to validate ILECs' information than they would under the AOCs' proposed rates.

Direct Cost Ratios

The Commission proposes that the ARMIS 43-04 and 43-01 reports be the basis for the development of direct cost to investment ratios for the LIDB validation query service. The AOCs do not oppose the use of such ratios as a reasonableness test, but believe that the ARMIS information does not provide the best source of information for direct cost development. Instead, the AOCs

⁴ While the cost of ILEC compensation is a part of the AOCs' cost of providing LIDB queries, that cost was not included in the AOCs' LIDB cost study because the AOCs did not know which ILECs would store their data with the AOCs or how many validations would be generated based on that data.

believe that their current methodology provides a more precise measure of direct cost factors for the LIDB service.

Direct cost factors calculated by the AOCs represent the yearly expenses generated as a result of the investment used to provide a service. There are two types of factors used to develop annual costs. The first, referred to as annual capital costs, includes depreciation, cost of money and income tax. The second type, referred to as operating expenses, includes maintenance and ad valorem taxes. A detailed discussion of each component of the direct annual charge factor is contained in the Direct Case of the AOCs, April 21, 1992, pp. 14-17 and Appendix B which are attached as Appendix 3.

As noted above, calculated using the AOCs' method, direct annual charge factors are specific to the plant accounts of the investment underlying the service. In the case of the LIDB Validation Query, the annual charge factor relative to the Switching Control Point (SCP) is developed using various parameters, such as the specific service/economic life, mortality curve, tax lives, salvage and maintenance for this particular type of equipment.

On the other hand, a direct cost factor developed from ARMIS data for Total Traffic Sensitive is not specific to the investment or plant account providing the service. It is at best, an average of several plant accounts, including a myriad of accounts for Cable and Wire, Interoffice Transmission and Central Office Equipment. Cable and Wire and Interoffice Transmission, for instance, include Plant Accounts 2232, 2411, 2421, 2422, 2423 and 2441 which have depreciation lives of 7, 35, 20, 20, 20 and 65 years respectively. With the exception of Account 2232, all other Plant Accounts far exceed the 7 year service life that was utilized for the direct annual charge factor for the LIDB Validation Query.

This difference in service lives directly impacts the calculation of depreciation expense which is a component of direct cost. Use of the ARMIS data results in a

depreciation expense level that is 28.5% lower than the expense that is calculated using the 7 year service life for the SCP investment specific to LIDB. Since

depreciation expense is the largest component of direct cost (see Appendix 2)

3. Basis of Ratemaking

LIDB Service will be used by network providers to validate end user requests to place alternately billed calls. Interexchange carriers validate Ameritech billing data today through either a validation service provider or through direct licensing arrangements. Under direct licensing arrangements, the licensing company can provide validation services itself. LIDB Service represents the introduction of validation services provided directly by Ameritech.

The major use of LIDB Service will be to validate charges to calling cards issued by an Ameritech Operating Company. As a result, Ameritech LIDB validation services and validation data are available largely as by-product of the offering and promotion of Ameritech Operating Company calling card services to end users as a convenient billing option, just as other issuers of credit cards offer validation services in conjunction with their billing services. The availability of AOC calling cards facilitates usage of both local exchange carrier and interexchange carrier networks. While some interexchange carriers offer their own calling cards to facilitate and promote use of their network to their end users, the Ameritech Operating Companies promote use of their cards on all networks².

LIDB Service is a billing service which is unrelated to the routing of the calls. The AOCs offer calling cards and validation service for interexchange carriers as part of a billing service. Interexchange carriers do not have to accept the AOCs' calling cards or validate calls in order to complete the calls. Thus, LIDB Service should not be required to be tariffed or subject to the Commission's Title II jurisdiction. The AOCs are filing this tariff as an interim measure pending the Commission's final decision in Docket No. 91-115.

LIDB Service is a new and discretionary service for which competitive alternatives exist. Thus, the only relevant test for establishing rate levels is the customer's willingness to pay and compliance with the Commission's net revenue test. Interexchange carriers have several billing options including the ability to issue their own calling cards, enter into an arrangement with a competitive credit card provider (VISA, Master Card, American Express,

² While the cost of promoting and issuing Ameritech calling cards is not reflected in the LIDB validation or transport query costs, it is clear that, in addition to promoting use of the Ameritech IntraLATA network, benefits accrue to all ICs from Ameritech calling card issuance and usage promotion activities. Ameritech's expenditures on calling card issuance and promotion in 1991 will exceed \$6,000,000 for the standard AOC calling card offering.

Discover, etc.) or make other billing arrangements with the customer. In fact, the interexchange carriers are doing all of these today. Several interexchange carriers, such as AT&T, offer their own credit cards and are fiercely promoting their use over other billing mechanisms. In addition, several interexchange carriers have entered into arrangements with competitive credit card companies (VISAPhone with MCI and Discover Card with Sprint). As a result of the existence of these alternatives, if the AOCs' LIDB validation rates are set too high, then interexchange carriers will not accept the AOCs' calling card or use LIDB Service, but will turn to other competitive billing services. Use of a strict cost plus pricing formula may also result in rates that are too low such that competition among billing service providers will be lessened. Thus, the only appropriate test for evaluating the reasonableness of rates is the net revenue test. As demonstrated herein, the AOCs' rates do produce a positive net revenue.

The charges for LIDB validation service compare favorably with the rates for similar competitive validation services. The total proposed charge for a validation query is \$.03, which is comprised of a LIDB Transport charge of \$.00012 and a LIDB Validation charge of \$.029880, both of which are required for every query. These charges are similar to the \$.038 charged by other validation service providers which license the AOCs' and other LECs' data. This price of \$.038 has undergone significant change going from \$.22 in 1988 to its current level as a result of competition among multiple validation providers. The proposed charge of \$.03 per query is therefore reasonable when compared to the charge for a competitively determined alternative. The charges are also above the incremental cost of providing the service, and will thus provide a contribution to the recovery of overhead costs.

As demonstrated by the net revenue test and the incremental cost data, the proposed rates do not result in a subsidy from any other service since the existence of a positive net revenue in the net revenue test required under Part 61.49 of the Commission's Rules effectively demonstrates that no subsidy flows to LIDB Service at the rates proposed in this filing.

While the use of incremental cost as an input to the net revenue test is clearly relevant to determine a minimum price for a service, most economists would agree that cost should provide little other input to the pricing process. For example, prices cannot simply be set at incremental cost. It is well known that if all prices were set at incremental cost in an industry characterized by economies of scale, the firm would be unable to recover its total cost of operation. Therefore, prices must be set somewhere above incremental cost such that the

sum of all charges covers the total cost of the firm... the difference between price and incremental cost provides a contribution to joint and common costs, or overhead. But the amount of contribution that each service provides in a multi-product firm can and should vary considerably, because there is no "best" amount of contribution that should be provided.

One common attempt at determining the "correct allocation" of total cost to each product is to use fully distributed costs. In spite of the well-known failings of fully distributed cost as a pricing standard, and the arbitrary nature of such allocations³, the AOCs have developed a form of fully distributed cost for the two components of LIDB Service. The only use of such a number, however, is for comparison to the contribution included in the proposed prices for LIDB queries. While for certain services which are interrelated it may be reasonable to expect approximately equal contribution margins to avoid discrimination between classes of customers, no such rationale exists for LIDB Service. No customer is either benefited or harmed compared to other customers by the level of contribution proposed for this service.

The proposed rates are just and reasonable since they pass the net revenue test and are above incremental cost. In addition, the proposed rates compare favorably with competitive alternatives. As stated previously, the very existence of these alternatives will ensure that the price is reasonable through market dynamics, and no further review should be required. Therefore, the proposed charges have been shown to be reasonable in all respects.

4. Demand

The LIDB query demand is based on historical demand for alternate billing services. The demand was grown each year to reflect an expected increase in IC requirements for support for alternate billing services. The demand was adjusted to take into account the replacement of shared AT&T/LEC calling cards with AT&T proprietary cards. (Query demand would decrease because AT&T proprietary card queries would not be handled by the LIDB). Demand was also adjusted because of an expected decrease in demand for collect calls. Historically, a significant portion of collect calls have originated from prisons. Changes in prison policy at selected facilities on telephone calling will enable inmates to place "sent paid" (paid for by the originator) rather than collect calls. The projected LIDB query demand is shown in Exhibit 6.

³ See, for example, Baumol, Koehn and Willig, "How Arbitrary is Arbitrary? - or, Toward the Deserved Demise of Full Cost Allocation," *Public Utilities Fortnightly*, Volume 120, Number 5, September 3, 1987, pp 16-21.

SERVICE DISCOUNT RATES FOR VISA PAYMENT TRANSACTIONS AVERAGING \$25, \$50, \$75 & \$100

<u>Estimated Annual Number of Transactions</u>	<u>Average Transaction Amount</u>	<u>Interchange Fees</u>	<u>Assessment Fees</u>	<u>Linkage and Authorization Access Costs</u>
100,000	\$ 25	\$0.3750	\$0.0173	\$0.0931
	50	0.7500	0.0345	0.0931
	75	1.1250	0.0518	0.0931
	100	1.5000	0.0690	0.0931
250,000	\$ 25	0.3750	0.0173	0.0781
	50	0.7500	0.0345	0.0781
	75	1.1250	0.0518	0.0781
	100	1.5000	0.0690	0.0781
500,000	\$ 25	0.3750	0.0173	0.0664
	50	0.7500	0.0345	0.0664
	75	1.1250	0.0518	0.0664
	100	1.5000	0.0690	0.0664
1,000,000	\$ 25	0.3750	0.0173	0.0630
	50	0.7500	0.0345	0.0630
	75	1.1250	0.0518	0.0630
	100	1.5000	0.0690	0.0630
5,000,000	\$ 25	0.3750	0.0173	0.0603
	50	0.7500	0.0345	0.0603
	75	1.1250	0.0518	0.0603
	100	1.5000	0.0690	0.0603
10,000,000	\$ 25	0.3750	0.0173	0.0599
	50	0.7500	0.0345	0.0599
	75	1.1250	0.0518	0.0599
	100	1.5000	0.0690	0.0599

FORMULA: Total Cost : Average Payment Dollar Amount = Discount Rate

DISCOUNT RATE - CREDIT CARD PAYMENT TRANSACTIONS AVERAGING \$25, \$50, \$75 & \$100

<u>Estimated Annual Number of Transactions</u>	<u>Average Transaction Amount</u>	<u>Interchange Fees</u>	<u>Assessment Fees</u>	<u>Linkage and Authorization Access Costs</u>
100,000	\$ 25	\$0.4450	\$0.0225	\$0.0931
	50	0.8200	0.0450	0.0931
	75	1.1950	0.0675	0.0931
	100	1.5700	0.0900	0.0931
250,000	\$ 25	0.4450	0.0225	0.0781
	50	0.8200	0.0450	0.0781
	75	1.1950	0.0675	0.0781
	100	1.5700	0.0900	0.0781
500,000	\$ 25	0.4450	0.0225	0.0664
	50	0.8200	0.0450	0.0664
	75	1.1950	0.0675	0.0664
	100	1.5700	0.0900	0.0664
1,000,000	\$ 25	0.4450	0.0225	0.0630
	50	0.8200	0.0450	0.0630
	75	1.1950	0.0675	0.0630
	100	1.5700	0.0900	0.0630
5,000,000	\$ 25	0.4450	0.0225	0.0603
	50	0.8200	0.0450	0.0603
	75	1.1950	0.0675	0.0603
	100	1.5700	0.0900	0.0603
10,000,000	\$ 25	0.4450	0.0225	0.0599
	50	0.8200	0.0450	0.0599
	75	1.1950	0.0675	0.0599
	100	1.5700	0.0900	0.0599

FORMULA: Total Cost + Average Payment Dollar Amount = Discount Rate

4. **The Factors Applied to Investment
Are Reasonable and Consistent.**

The Bureau asks filing carriers to identify and fully document the factors applied to the investment to develop costs, cross-referencing to ARMIS data, where appropriate.

a. **Direct Annual Cost Factors.**

Tax depreciation is the schedule of expense deductions used in calculating income tax liability. Income tax regulations allow for the use of accelerated tax depreciation and shortened prescribed tax lives for most new investments. With accelerated tax depreciation, tax depreciation expenses are greater during the earlier years of an asset's life, than in later years. Although tax depreciation is not a component of recurring capital costs, it does affect income tax liability.

The depreciation component of the capital costs of the services reflects an economic life of seven years and a net salvage value of 15.83%. The resulting factor of 0.1399 was calculated by dividing levelized depreciation costs by the total investment.

2. Cost of Money.

Investors' capital is used to purchase telephone plant used to provide the services. As a result, it is necessary to pay a return to investors for the use

$$\begin{array}{ccccc} \text{Return on} & & \% \text{ of Equity} & & \text{Equity} \\ \text{Equity (12.5\%)} & \times & \text{in Capital} & = & \text{Earnings} \\ & & \text{Structure (65\%)} & & \text{Fraction (8.1\%)} \\ & & \% \text{ of Debt} & & \end{array}$$

The maintenance factors used in these studies represent the relationship between maintenance expense and investment. This ratio of maintenance expense to investment is based on data from the general ledger (total year expenses and investments). The end of period account balances reported in corporate general ledgers were used to develop average annual investments for each plant account and average annual expense in each associated maintenance account. These averages are based on three consecutive years of data. Current Costs/Book Cost ratios were developed and used to convert each year's average investment to a dollar value consistent with expense dollars associated with that investment. The resulting maintenance factor used for the SCP and STP investment is 0.0726.

2. Ad Valorem Tax.

The ad valorem tax factor used in these studies represents taxes levied by some states on the assessed value of plant used to provide the services. The factor includes personal property and capital stock taxes and is applied to total investment. The ad valorem tax factor used in the studies is 0.003.

d. Overhead Loading.

A Fully Distributed Cost (FDC) Annual Charge Factor (ACF) was developed for the studies from the 1990 ARMIS Report for Local Transport. The FDC ACF represents the annual costs associated with Local Transport investment as determined by Part 69 Rules. This factor was calculated by dividing the portion of total direct and indirect costs allocated to Local Transport by the portion of equipment investment allocated to Local Transport. The factor is 1.4404.

**AMERITECH
DIRECT ANNUAL COST FACTOR**

STP/SCP INVESTMENT

L1	DEPRECIATION	0.1399
L2	COST OF MONEY	0.0521
L3	INCOME TAX	0.0235
L4	TOTAL CAPITAL COST FACTOR (L1+L2+L3)	0.2155
L5	MAINTENANCE	0.0726
L6	AD VALOREM TAX	0.0030
L7	OPERATING EXPENSE FACTOR (L5+L6)	0.0756
L8	TOTAL ANNUAL COST FACTOR L4+L7	0.2911 *

***Direct Annual Cost Factor that appears in Transmittal 574, Exhibit 4 and Transmittal 575, Exhibit 3.**